No. 15815

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

vs.

GRACE H. CUNNINGHAM, EUGENE F. CUNNINGHAM and GRACE H. CUNNINGHAM, *Respondents.*

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

ANSWERING BRIEF OF RESPONDENTS

OGDEN & OGDEN
Attorneys for Respondents.

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ANSWERING BRIEF OF RESPONDENTS

Come now the Respondents and for answer to the Brief of the Petitioner respectfully state as follows:

As set forth in the Brief for the Petitioner there are two causes of action, Docket 55091 and 55090, which were consolidated for hearing before the Tax Court and are now consolidated for hearing in this Court. The facts as respects the two cases are identical, except in 55090 the alleged deficiency of $6,725.59 occurred in the tax return of Grace H. Cunningham in the year 1946, and in cause number 55091, the second alleged deficiency of $9,528.54 occurred in the year 1952. Inasmuch as the claim for deficiency in the two tax returns are based upon identical facts they are admittedly inconsistent and recovery, if any, cannot be had on both.

AS RESPECTS THE QUESTION PRESENTED BY PETITIONER

The real question presented is: Did the cost of the improvements placed by the American Manufacturing Company, lessee, upon the real property of the Respondents, lessors, represent in whole or in part a liquidation in kind of lease rentals and therefore constitute taxable income to the Respondents? The Tax Court held the said improvements did not constitute rental and, therefore, the Respondents did not realize taxable income as the result of such improvements, either at the time of construction thereof or upon the termination of the lease. From this holding of the Tax Court, Petitioner has appealed.

The statutes involved are correctly stated by the Petitioner on Page 3 of his brief. The example shown on Pages 4 and 5 of Petitioner's brief appeared in Regulation 111, Internal Revenue Code, Sec. 29.22 (b) (11) -1. However, the last 16 lines thereof commencing with the word "If" do not again appear in any subsequent regulations.

STATEMENT

The Statement of Petitioner is in the main correct, although considerably curtailed.

The Respondents therefore desire to make an additional statement which may in some respects be repetitious.

Throughout this brief we will designate the American Manufacturing Company as "Company," except in cases of direct quotes.

From time to time throughout this brief we will direct the Court's attention to a colored map, facing page 7 hereof, which map sets forth in color the various property holdings, the various lots, owned by the Company and by the Respondents. It also shows the lots upon which the improvements were made, which map we hope will be of real assistance to the Court.

1. In 1928 Grace H. Cunningham began the manufacture of heavy steel machinery and equipment at the present location of the Company's plant (R. 125). In 1936 the Company was incorporated, occupying the same property that Grace H. Cunningham had theretofore been using.

2. From 1928 on through to 1944 Grace H. Cunningham, and later the Company, occupied Lots 7 to 12 in Block 2102, as shown in said map (R. 94, 130). During this period of time the Respondents and the Company filled these lots so that they became usable in their entirety (R. 64, Para. 20, 21). During this period of time neither Grace H. Cunningham nor the Company ever paid any rental or taxes on said lots, with the exception of $10.00 a month for a few months in 1943 (R. 59, 64, Para. 22).

3. In 1943 the Company erected an open craneway on Lot 9 for use in moving heavy equipment and machinery (R. 32).

4. In 1944 the Company was in need of additional space for their plant, but were not financially able at that time to purchase Lots 7 to 12, as shown on the map (R. 129, 132).

5. In October of 1944 Grace H. Cunningham purchased Lots 7 to 12 for $8,000.00 (R. 59). The purchase was made for the sole use and benefit of the Company so that the plant could be enlarged (R. 95, 129). If the Company could not find space at their present location to enlarge its plant, it would have been necessary for the Company to move (R. 95, 126).

6. Immediately following the purchase of these lots by Grace H. Cunningham in October, 1944, the Company placed a roof over the craneway on Lot 9 (R. 128) and closed in the south side with large glass windows and hollow cement tile at a cost of $2,800.00 (R. 33, 36, 65).

7. In 1945 Eugene F. Cunningham, who owned Lots 4, 5 and 6, commenced building a warehouse known as the Graybar Building, on Lots 4, 5 and 6, but found himself in need of additional space and purchased from Grace H. Cunningham Lot 7 (R. 33, 106).

8. In November and December of 1945 Eugene F. Cunningham built the wall running between Lots 7 and 8, which wall constituted the south wall of the Graybar Building and the north wall of the improvement being built by the Company on Lot 8 (See map) (R. 141). This wall was constructed as a party wall, owned half by Eugene F. Cunningham and owned half by the Company and Grace H. Cunningham (R. 140, 141).

9. By the end of 1945 the alley between Blocks 2103 and 2102 had been filled and surfaced (see map) at a cost to the Company of $2,755.00 (R. 36, 62, 63, 65). The cost of the party wall was $4,734.00 (R. 37, 62, 65). The cost of the improvements on Lots 8 and 9 were $2,800.00

(R. 36, 65). These funds were all spent in the year 1945 (see map) (R. 65, Para. 23).

10. On or about the last week in December of 1945 an oral agreement was entered into between Grace H. Cunningham, as owner of Lots 8 to 12, inclusive, and the Company, whereby it was agreed that Grace H. Cunningham would lease to the Company these lots for a period of six years. The Company agreed to pay all taxes and insurance, all costs of upkeep, and at the end of the six-year period to transfer to Grace H. Cunningham all improvements placed upon the property, either before the date of the oral agreement or subsequent thereto. The Company was to pay no rent (R. 129, 130, 132).

11. Subsequent to the oral agreement and in the first two months of 1946, the Company spent $11,097.00 in completing the improvements (R. 36, 65, 132). This gave the Company an enclosed structure 50 feet x 120 feet with a craneway on both Lots 8 and 9.

12. On the 17th day of March, 1947, a written lease was entered into between Grace H. Cunningham as lessor and the Company as lessee (Ex. 1-A, R. 67-70).

13. On the 29th day of March, 1946, a written party wall agreement was entered into (Ex. 3-C, R. 73) although the party wall itself had been built under an oral agreement in November and December of 1945 (R. 140, 141) which was not reduced to writing until the 29th day of March, 1946 (R. 73, 74, 75).

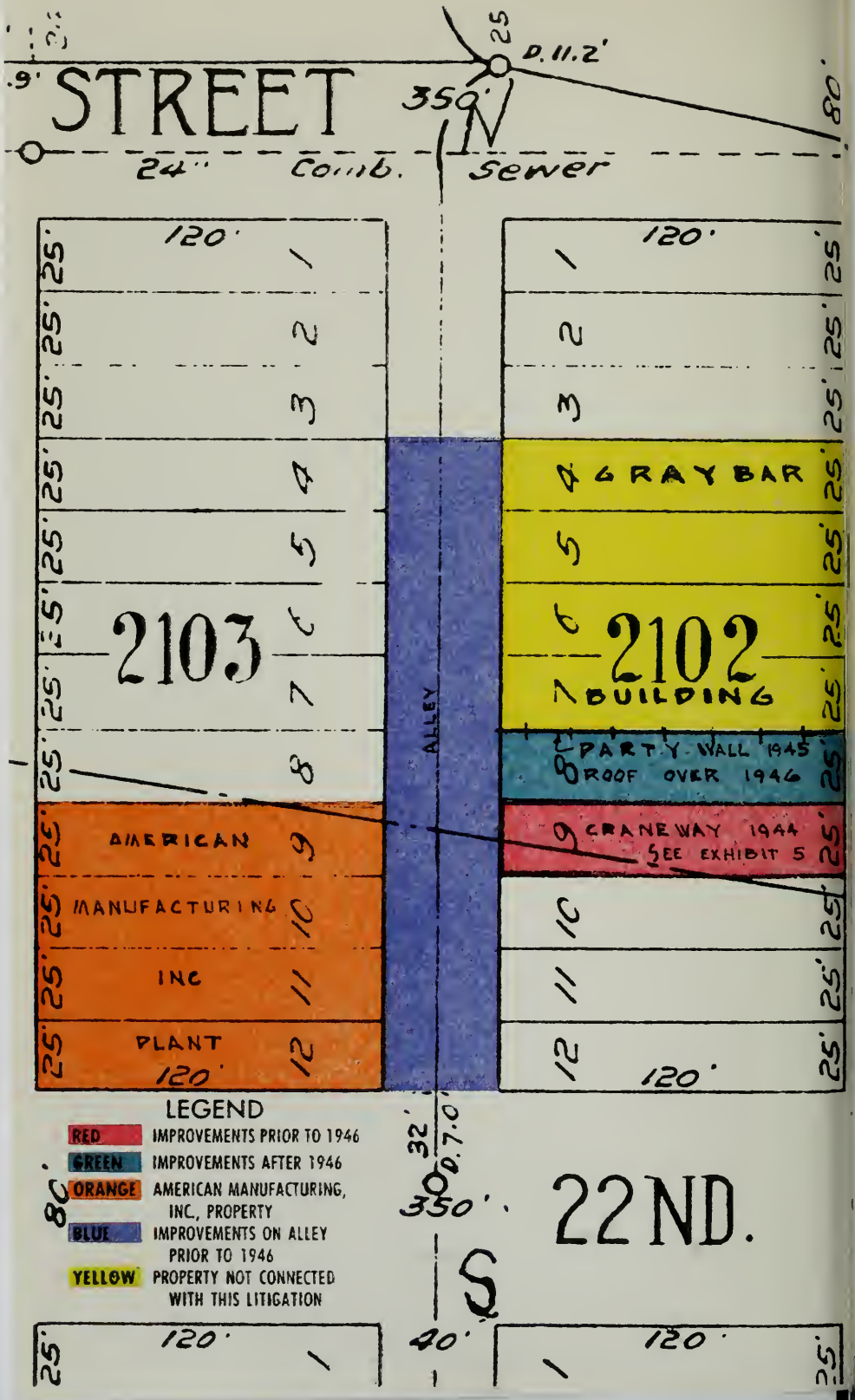
14. Respondents testified that the life of the improvement would not exceed 20 years (R. 108). By the

time the present lease expires in 1962, the building will be obsolete and will have to be torn down and a new type of building put up (R. 136). That the improvements erected by the lessee were of a special type, adapted to the Company's special use in the type of manufacturing in which they were engaged. That the building is one story and very high and would have no use to anyone unless they were engaged in the same type of manufacturing, and that there was no one in the City of Tacoma engaged in that business (R. 108, 109, 136, 137).

15. Grace H. Cunningham testified that as an owner of the real property, if she were not connected with the Company, or if she should severe her connections with the Company, she would want an agreement that the Company would remove these buildings and improvements so placed upon the realty at the expiration of the present lease in 1962. She stated that the improvements that had been placed upon the realty did not add any value whatsoever to the realty, this because of the nature and character of the building (R. 136, 137, 138).

16. Grace H. Cunningham testified that she carried no insurance on the building, and that the insurance policy carried on the building by the Company did not include any personal protection for her. She did not believe the building was of any value to herself as a property owner (R. 140, 141).

17. On the 14th day of January, 1952, the written lease of March 17, 1947, having expired by its terms, a new written lease was entered into (Ex. 4-D, R. 76, 77). Under the terms of which lease Lots 8 and 9 and the East 40 feet of Lot 10 were leased to the Company for a


STREET
24" Comb. Sewer
D. 11.2'
350'
120'
2103
2102
ALLEY
AMERICAN
MANUFACTURING
INC
PLANT
4 GRAY BAR
BUILDING
PARTY WALL 1945
ROOF OVER 1946
CRANEWAY 1944
SEE EXHIBIT 5
LEGEND
RED IMPROVEMENTS PRIOR TO 1946
GREEN IMPROVEMENTS AFTER 1946
ORANGE AMERICAN MANUFACTURING, INC., PROPERTY
BLUE IMPROVEMENTS ON ALLEY PRIOR TO 1946
YELLOW PROPERTY NOT CONNECTED WITH THIS LITIGATION
22ND.
D. 7.0'
32'
40'
80'

period of ten years at the rental of $10 per month plus taxes and insurance. These were the lots upon which the improvements were situated. Any improvements placed on the realty during said period to revert to the lessors at the end of the period. A more complete statement of facts is found in the Opinion of the Tax Court (R. 29-44) and in the stipulated facts (R. 55-67).

AS RESPECTS PETITIONER'S STATEMENT OF POINTS URGED IN 55091

As respects point number 1, this point involves the findings of fact of the Tax Court. If the Petitioner would accept as true the findings of the Tax Court, then there could be no error "as a matter of law." Petitioner does not even allege that there would be. He takes the position that the Tax Court's findings are incorrect and supplements his own therefor, and on such supplemented statement of facts the alleged error of point 1 is based.

Point 2 involves in its entirety a challenge of correctness as to the facts found by the Tax Court.

Point 3 alleges error on the part of the Tax Court in failing to find the amount of income received in 1952 by taxpayers Eugene F. Cunningham and Grace H. Cunningham attributable to the improvements placed upon the property by the lessee. Inasmuch as the Tax Court found that there was no income received in 1952 by taxpayers which was attributable to improvements placed upon the property by the lessee, there was no occasion to go into the question of the amount of the income, they having found there was none. The question raised in Point 3 is moot.

AS RESPECTS PETITIONER'S STATEMENT OF POINTS URGED IN 55090

They are identical with the points urged in Cause 55091, except 1946 is substituted for 1952, and our answer is the same.

Before proceeding further, we desire to call the Court's attention to the well-established rule which now prevails in all the Circuit Courts with respect to the rights and powers of the Circuit Courts in matters of appeal from decisions of the Tax Courts.

It was said in *Helvering v. National Grocery Co.,* 304 U.S. 282 at 294, 82 L.ed. 1346 at 1356:

> "The Court of Appeals, instead of limiting its review to ascertaining whether there was evidence to support the Board's findings and decision, made on all the evidence, as upon a trial de novo, in effect, an independent determination of the matters which had been in issue before the Board. The Court was without power to do so. Helvering v. Rankin, 295 U.S. 123, 131, 132, 79 L.ed. 1343, 1349, 1350, 55 S.Ct. 732. To draw inferences, to weigh the evidence and to declare the result was the function of the Board. Hulburd v. Commissioner of Internal Revenue, 296 U.S. 300, 306, 80 L.ed. 242, 246, 56 S.Ct. 197; Elmhurst Cemetery Co. v. Commissioner of Internal Revenue, 300 U.S. 37, 40, 81 L.ed. 491, 492, 57 S.Ct. 324."

Perhaps no Circuit has been more zealous in following this rule than our own Ninth Circuit.

Grace Bros. v. Commissioner of Internal Revenue, 173 F.2d 170 at 173, 9th C.C.A. Feb. 18, 1949:

> "By recent statutory enactment, Internal Revenue Code, Section 1141(a), as amended by Sec-

tion 36, Public Law 773, 80th Congress, Second Session, 26 U.S.C.A. §1141(a), it is decreed that this Court's jurisdiction to review shall be 'in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury.' This reads into the Internal Revenue Code the provision of the Federal Rules of Civil Procedure that:

"'Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.' Rule 52(a), Federal Rules of Civil Procedure, 28 U.S.C.A."

Joe Balestrieri & Co. v. Commissioner of Internal Rev., 177 F.2d 867 at 873, 9th C.C.A. Nov. 15, 1949:

"In our consideration of the questions of law presented on the merits we have taken the facts to be as found by the Tax Court for the reason that upon consideration of the entire record it appears to us that the court's findings are supported by substantial evidence and are not clearly erroneous."

Particelli v. Commissioner of Internal Revenue, 212 F.2d 498 at 500, 9th C.C.A. May 5, 1954:

"[3, 4] The determination of whether the written contract reflected the real agreement between the parties was a question of fact and the Tax Court's finding with respect thereto is final if based upon substantial evidence. Commissioner of Internal Revenue v. Tower, 1946, 327 U.S. 280, 66 S.Ct. 532, 90 L.Ed. 670. We find substantial evidence in this case to support the Tax Court's conclusion that the substance of the transaction was a sale of the wine and winery for a total price of $350,000 without any bona fide agreement as to the real sales price of each piece of property involved."

Accord:

E. L. Bride, et al., v. Commissioner of Internal Revenue, 224 F.2d 39 at 42 [1], 8th C.C.A. Aug. 1, 1955;

Alice E. Cohn, et al., v. Commissioner of Internal Revenue, 226 F.2d 22, 9th C.C.A. Oct. 1, 1955;

Golden Construction Co. v. Commissioner of Internal Revenue, 228 F.2d 637, 10th C.C.A. Dec. 24, 1955.

David Pleason v. Commissioner of Internal Revenue, 7th C.C.A. Nov. 2, 1955, 226 F.2d 732 at 733:

"[1] Petitioner, sometimes spoken of herein as taxpayer, seeks to set aside the decision of the Tax Court of the United States establishing certain deficiencies in income and victory taxes for the year 1943, in income tax for the year 1944 and penalties for those years. The findings of fact and the opinion of the court are reported in 22 T.C. 361. Inasmuch as it is the function of the trial court to weigh the evidence, draw inferences and declare the result, Matthiessen v. Commissioner, 2 Cir., 194 F.2d 659; Burford-Toothaker Tractor Co. v. Commissioner, 5 Cir., 192 F.2d 633, certiorari denied 343 U.S. 941, 72 S.Ct. 1033, 96 L.ed.1 347, our only function is to determine whether the findings are clearly erroneous, that is whether upon the whole record, there is substantial evidence to support them and whether the court erred as to the law. Inasmuch as the findings have been fully reported, we shall not repeat them. However, we have scrupulously examined the record, and are convinced that they are amply supported by the evidence and that the inferences drawn by the Tax Court are entirely reasonable."

Such being the law, we shall endeavor to show this Court that the Findings of Fact of the Tax Court, as well as its ultimate decision, are fully supported by the evidence and surrounding circumstances, and that the facts as found by the Tax Court leave no room for errors of law.

REFERENCE TO PETITIONER'S SUMMARY OF ARGUMENT

Of necessity, Respondents' Order of argument will have to follow closely the order of the Petitioner's argument. It is Respondents' position that fundamentally there is but one question which in itself is determinative of this appeal.

Two statutes are involved; the first is now Section 109 of the 1954 Code. It reads as follows:

> "§109. **Improvements by lessee on lessor's property.** Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee. Aug. 16, 1954, 9:45 a.m., E.D.T., c. 736, 68A Stat. 33."

Also the section now known as 1019 of the 1954 Code, which reads as follows:

> "§1019. **Property on which lessee has made improvements.** Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 109 (relating to improvements by lessee on lessor's property). If

> an amount representing any part of the value of real property attributable to buildings erected or other improvements made by a lessee in respect of such property was included in gross income of the lessor for any taxable year beginning before January 1, 1942, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. Aug. 16, 1954, 9:45 a.m., E.D.T., c. 736, 68A Stat. 301."

The question is: Did the facts in this case disclose that the building and improvements placed upon the leased property by the lessee company represent in whole or in part a liquidation in kind of lease rentals? The Tax Court answered the question as follows (R. 53):

> "We are satisfied from this testimony and from the acts of the parties to the lease that they did not intend that the value of the improvements should constitute rent either at the time of construction or at the termination of the lease. We have therefore concluded and found as a fact that the value of such improvements made by the lessee did not represent rent at the time of construction or upon termination of the lease. It follows that the petitioners did not derive income attributable to such improvements either in 1946 or in 1952."

ANSWER TO SUBDIVISION A OF PETITIONER'S BRIEF

We now consider Petitioner's argument under his heading "A. The law." Under this section of his brief the Petitioner is seeking a new and weird construction of the 1942 Amendment, which is now Section 109 (1954 Tax Code). Here it is argued that the amendment should be so construed as to limit its intent to so-called

windfalls, *i.e.*, cancellation of leases. He argues that the word "termination" in the Act should be so construed as to mean "cancellation of a lease."

The Commissioner herein seeks to inject into this case for the first time a theory not even suggested in any of the various hearings that lead up to the trial in the Tax Court, nor was the slightest suggestion made in the Tax Court as to such a position. In fact, on page 13 of the Commissioner's brief in the Tax Court it is stated in reference to the 1942 amendment:

> "It is apparent that Congress specifically intended to eliminate the application of the *Bruun* case, as the section applies exclusively to the year of termination of the lease."

Again on page 14 of the Commissioner's brief before the Tax Court, it is stated referring to the minutes of December 15, 1945:

> "This language indicates that the erection of the improvements was the substitute for, or in lieu of, a regular periodic cash rental."

It was the position of the Commissioner before the Tax Court that the cost of the improvements placed upon the leased premises constituted a liquidation in kind of lease rentals.

The conclusion reached by the Petitioner in his brief here on page 23 is:

> "Thus, it is clear that the 1942 statutory amendment did not have any application to income representing a liquidation in kind of lease rentals attributable to improvements erected by a lessee, but was enacted to prevent the taxation of income which represented a windfall from cancellation of

> a lease. Thus, the question presented here is whether the enhanced value attributable to the improvements constitutes rent."

This Court in *Lewis v. Pope Estate Co.,* 116 F.2d 328, 330, 9th C.C.A., Dec. 17, 1940, states:

> "In both of those cases title to the improvements passed to the lessors upon completion of the construction, and there would be no reason for the reversals if such distinction controlled. We are therefore of the opinion that the time when title to the improvements passes to the lessor is immaterial, and that the real question is when the lessor 'realizes' income; . . . "

The 1942 amendment was passed for the purpose of excluding from gross income any income derived by a lessor of real property on the termination of the lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee, unless the same represents in whole or in part liquidation in kind of lease rentals.

The contention of the Petitioner is best answered by Treasury Regulations 111, Section 29.22 (b) (11) -1, being Regulation 1.109-1 of Federal Tax Regulations of 1958. Here the following language is used:

> "**Exclusion from Gross Income of Lessor of Real Property of Value of Improvements Erected by Lessee.** Income derived by a lessor of real property *upon the termination, through forfeiture or otherwise,* of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income." (Emphasis ours)

Surely this portion of the Treasury Regulation is

diametrically opposed to the conclusion reached by the Petitioner in his brief on page 23. Again the wording of the regulation is:

> "However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation."

Again this statement in the Treasury Regulation is diametrically opposed to the conclusion in Petitioner's brief under its heading "A. The law," as set forth on page 23.

Section 109 contains but five lines, it states:

> "Gross income does not include income (other than rent) derived by a lessor of real property on the *termination of a lease,* representing the value of such property attributable to buildings erected or other improvements made by the lessee." (Emphasis ours)

Every Regulation since the passage of the Act reads as follows:

> "Income derived by a lessor of real property upon the *termination,* through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon leased property is excluded from gross income." (Emphasis ours)

This Act has been in force since 1942. So far as shown in Shepard's, the Act has only been referred to twice, once in the case of *Beck v. F. W. Woolworth Co.,* 111 F.Supp. 824, where on page 830 the Court speaks as follows:

> "It might be noted that formerly it was held that the value of an improvement erected by the lessee, and not removable by him, was income to the lessor for federal income tax purposes when the lease terminated. Helvering v. Bruun, 1940, 309 U.S. 461, 60 S.Ct. 631, 84 L.ed. 864. But now the statute provides the contrary. Internal Revenue Code, §22 (b) (11), 26 U.S.C.A. 1 American Law of Property, §3.77 (1952)."

And again in *First National Bank of Kansas City v. Nee,* 190 F.2d 61, where on page 68 the Court speaks as follows, referring to the rule in *Helvering v. Bruun,* 309 U.S. 461, 60 S.Ct. 631, 84 L.ed. 864, relating to:

> " . . . the cancellation of a long-term lease and the return to the lessor's devisees of the leased premises together with a valuable building erected by the lessee."

Here appears a note at the bottom of the page, the note reads:

> "Parenthetically, a problem which would not occur at this time, since intervening legislation has eliminated the taxability of such a situation."

This Court has in times past had a great deal of experience with this particular problem which had vexed all our Federal Courts for a period of 40 years or more, namely: the disposition to be made, taxwise, of buildings or other improvements placed upon leased premises by the lessor, which, under the terms of the lease, revert to the lessor, either at the termination of the term of lease or its earlier termination by forfeiture or otherwise. There was little unanimity of opinion among the various Circuit Courts.

By the amendment of 1942 (109 of 1954 Tax Code), it was the intent of the Congress to put an end once and for all to this vexatious problem and to make it clear that whenever the lessor came into possession of buildings erected by the lessee upon leased property that the same would not constitute gross income, and therefore the same should be excluded from gross income excepting only when the improvements constituted a liquidation in kind of lease rental. The result of this Act was not to relieve the lessor from the payment of any tax if he actually received value flowing from such reversion. Accordingly, Section 113 (c) of the 1939 Code was amended in 1942 (See Section 1019 of the 1954 Tax Code). This amendment provided that neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excluded from gross income of Section 109 (relating to improvements by lessee on lessor's property).

It is clearly the intent of the Petitioner in this appeal to seek a decision from this Court limiting the exemption from gross income contained in Section 109 by construing the word "termination" therein used to mean "cancellation of a lease," this he designates as "windfalls." If his position should be sustained, it would bring back on the taxrolls property measured not in thousands, but in millions of dollars. Such a conclusion would defeat the very purpose of the Act and would again leave open the very vexatious problems the Act was intended to solve. It is not believed that this

Court will give heed or credence to this alleged strained and impossible construction of said Section 109 (being the 1942 amendment so frequently referred to).

As respects Subdivision "A. The law" of Petitioner's brief, this whole section must be entirely disregarded for the reason that this section injects into this case a new theory not heretofore presented to the Tax Court. As we have pointed out in the beginning of the discussion of "A. The law" the brief of the Commissioner in the hearing before the Tax Court distinctly relied upon the theory that the improvements placed by the lessee on property of the lessor, Respondents here, represented in whole a liquidation in kind of lease rental. Therefore, the exclusion from gross income did not apply.

It is the law that on appeal the appellant, herein designated Petitioner, must adhere to the theory on which the case is tried in the lower Court. See *Kirk v. St. Joseph Stockyards Co.,* 206 F.2d 283 at 287, 40 A.L.R.2d 980, 8 Cir. 1953, where it is said:

> "It is elementary that on appeal the appellant must adhere to the theory on which the case was tried in the lower court. Barnsdall Refining Corporation v. Cushman-Wilson Oil Co., 8 Cir., 97 F.2d 481; Petersen v. Chicago, Great Western Ry. Co., 8 Cir., 138 F.2d 304; Valley Shoe Corporation v. Stout, 8 Cir., 98 F.2d 514; Gulf, Mobile & Ohio R. Co. v. Williamson, 8 Cir., 191 F.2d 887. In Valley Shoe Corporation v. Stout, supra, we said [98 F.2d 518]: 'Moreover, this Court, on appeal, must adhere to the theory upon which the case was tried in the lower court.' And in Barnsdall Refining Corp. v. Cushman-Wilson Oil Co., supra, we said [97 F.2d

485]: 'We must, on appeal, adhere to the theory on which the case was tried in the lower court.' Any other practice would be manifestly unfair to an appellee and to the trial judge."

It is not believed this Court will accept the strained construction sought by the Petitioner.

ANSWER TO SUBDIVISION B OF PETITIONER'S BRIEF

Here the Petitioner is challenging the correctness of certain findings of the Tax Court. Petitioner states on page 23 of his brief, as follows:

> "The Tax Court concluded (R. 53) that the parties to the lease 'did not intend that the value of the improvements should constitute rent' and concluded 'that the value of such improvements made by the lessee did not represent rent' based upon its findings that the parties did not so intend. We submit that the Tax Court erred as a matter of law in reaching this conclusion."

The facts are that the improvements made in 1945 were made merely by consent of Respondents; those in 1946 were made under an oral agreement, sometimes designated as "oral lease." The terms and conditions of such oral lease were testified to by both Respondents.

It is true that on the 15th day of December, 1945, at a meeting of the Board of Directors of the Company, it was announced that Grace H. Cunningham was willing to lease to the Company, *free of any rent* except payment of taxes, Lots 8 to 12 in Block 2102 of Tacoma Land Company's 5th Addition to Tacoma, Pierce County, Washington. This said property (see map) was stra-

tegically situated and would make an ideal building site for the Company's needed improvements. The minutes of said meeting of the Directors did not constitute the oral lease. Throughout Petitioner's brief, reference is frequently made to the minutes of this meeting of December 15th as though the same constituted the oral lease, which, of course, is not the fact.

It is the testimony of Respondents that the oral lease positively provided that there should be no rental of any kind paid by the Company for the use of said Lots 8 to 12, inclusive, excepting payment of taxes, this for the following reasons:

1. The Company had been using these lots for many years without rent.

2. The Company had transformed the lots from an unusable physical condition to level usable condition, by filling in parts of the lots that were 40 feet below grade.

3. In 1944 Grace H. Cunningham purchased these lots specifically for the continued use of the Company, without rent, just as they had always been.

Grace H. Cunningham testified as follows (R. 129):

> "Q. Will you state to the Court why you bought these lots?
>
> A. I bought them so that my company, the American Manufacturing Company, had working space. They couldn't afford to [54] buy them themselves." . . .
>
> "Q. (By Mr. Ogden) At this time in 1945, the latter part thereof, was there any negotiations entered into between the American Manufacturing

Company and yourself respecting these lots in question, the five lots?

A. They were to use the five lots for nothing, provided they paid the taxes, any improvements that they put on them were not to be of any cost to me. They had been using them since 1928 and they wanted to continue on using them.

Q. Was there at the time of this arrangement, namely, the agreement you refer to of the last part of 1945, was there an oral agreement covering what they might do with these lots?

A. Yes.

Q. Now, state to the Court what that oral agreement was?

A. The oral agreement was that they were to, that they could erect an addition to the present craneway.

Q. That would cover what lot?

A. Lot No. 8.

Q. And what was on the other side of Lot No. 8?

A. The Graybar Building. [55]

Q. Lot No. 8 was 25 feet in width the same as 9?

A. Correct, by 120 feet long.

Q. State to the Court whether or not there was any intent on the part of yourself as owner of these five lots and the American Manufacturing Company relative to rent?''

Following this question, there was an objection made by Mr. Welch, a colloquy between the Court, the witness Grace H. Cunningham, and Mr. Ogden ensued. At the close of which colloquy the objection was overruled and the witness instructed to answer (R. 132).

''A. I had no intent of rent. I was only concerned

with acquiring additional space for my company so that they could exist in that location.

"Q. (By Mr. Ogden) Do you know whether or not the American Manufacturing Company, after January 1, 1946, did place any improvements on this property?

A. They placed a 25 by 120-foot structure, a roof, a floor, and two ends which adjoined the Graybar Building.

Q. The stipulation entered into and now on file states that the cost of this improvement to which you have just testified was $11,094?

A. Correct.

Q. Does $11,094 represent the amount paid by the American Manufacturing Company for these improvements?

A. That is right. [58]

Mr. Ogden: I am going to ask this exactly in the wording of the Commissioner in his letter.

Q. (By Mr. Ogden) Were these the improvements that were to revert to you under the terms of the lease on the first day of January, 1952?

A. Yes, correct." (R. 133) (See also Eugene F. Cunningham, R. 97, 98)

The foregoing constitutes the testimony relative to the terms of the oral agreement, or lease, so far as the same related to rental.

Sec. 12 of the Stipulation of Facts (R. 61) reads as follows:

"Grace H. Cunningham, being the largest stockholder and manager of said American Manufacturing Company, was desirous of permitting the company to expand its business and obtain the then

necessary room by changing the craneway into a complete structure."

On March 17, 1947, over a year after the improvement placed by the Company on the lots in question had been completed, a written lease was executed (R. 67), reading in part as follows (R. 68):

> "The consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee *has* in a building which lessee *has* constructed and *paid for* on the above-described property." (R. 35, 67) (Emphasis ours)

On page 24 of his brief Petitioner states:

> "However, where, as here, the sole specified consideration for occupancy (except the payment of taxes) is 'construction of a building on said premises of the approximately value of $25,000.00' . . . "

Such are not the facts, either under the oral lease of January 2, 1946, or under the written lease of March 17, 1947. The only place where the words "construction of a building on said premises of the approximate value of $25,000.00" is found is in the minutes of the meeting of December 15, 1945. Recitals in the minutes of a meeting of a Board of Directors of a corporation do not constitute a contract, nor do they constitute a lease, oral or written.

The only two leases that can possibly affect the facts in this case are the oral lease of January 2, 1946, and the written lease of March 17, 1947, in neither of which leases was the "sole" consideration for the granting of the lease the right of reversion to the lessor of the im-

provements placed upon the leased premises by the lessee.

As heretofore pointed out, Grace H. Cunningham testified there was to be no rent; the minutes of December 15, 1945, also declare that there shall be no rent; that the payment of rent was not the consideration; that the true consideration for the lease was the erection of buildings and improvements on the leased premises which would permit the Company to continue its manufacturing business without the necessity of moving from their then plant location (R. 126).

Petitioner does not cite one single case which holds that oral testimony is not permissible in proving the terms of an oral lease. How else could it be proven? It must be remembered that it was under this oral lease that these improvements were constructed.

Great strength is added to the testimony of the Respondents by the treatment given this matter in the Company's books. There it is disclosed that the total cost of the improvements, in the sum of $21,904.33, was capitalized. This capitalized amount was then by the Company depreciated over the period of the lease (R. 66, Para. 29).

It is clear that the value of the improvements placed upon the leased premises cannot be capital to the lessee, and at the same time rental to the lessor.

It is respectfully submitted that no stronger evidence of the intent of the parties could be found than in the method in which each treated the cost of the improvements placed upon the property, both before and after January 1, 1946 (R. 66, Para. 29).

Petitioner states on page 23 that the conclusion of the Tax Court that the parties "did not intend that the value of the improvements should constitute rent," was reversible error.

It is difficult for us to find in the whole of Subdivision B of Petitioner's brief the reason why he asserts that this conclusion of the Tax Court was erroneous.

Certain it is that in his citation of supporting authorities his first citation of *M. E. Blatt Co. v. United States,* 305 U.S. 267, 83 L.ed. 167, can afford him no basis for the conclusion reached under Subdivision B. In the *Blatt* case the Court on page 170 of 83 L.ed., 277 of 305 U.S., defines what does or does not constitute rent, as applied to improvements placed upon leased premises by lessee:

> "There is nothing in the findings to suggest that cost of any improvement made by lessee was rent or an expenditure not properly to be attributed to its capital or maintenance account as distinguished from operating expense. While the lease required it to make improvements necessary for successful operation, no item was specified, nor the time or amount of any expenditure. The requirement was one making for success of the business to be done on the leased premises. It well may have been deemed by lessor essential or appropriate to secure payment of the rent stipulated in the lease. Even when required, improvements by lessee will not be deemed rent unless *intention that they shall be is plainly disclosed.* Rent is 'a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property . . . ; . . . it does not include payments, uncertain both as to amount and time, made for the cost of improvements. . . . ' The facts

found are clearly not sufficient to sustain the lower court's holding to the effect that the making of improvements by lessee was payment of rent." (Emphasis ours)

Here the Supreme Court of the United States states unequivocally that improvements placed by the lessee on lessors' lands will not be deemed rent *unless the intention so to do is clearly disclosed,* and yet this very case is cited by the Petitioner as authority for holding that the Tax Court committed error in permitting evidence to be introduced to show the intent of the parties.

Again in *Duffy v. Central R. Co.,* 268 U.S. 55 at 62, 69 L.ed. 846 at 848, cited by Petitioners, the Court states:

"Clearly, the expenditures were not 'expenses paid within the year in the maintenance and operation of its [respondent's] business and properties;' but were for additions and betterments of a permanent character, such as would, if made by an owner, come within the proviso in subd. second, 'that no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property, etc.' They were made, not to keep the properties going, but to create additions to them. They constituted, not *upkeep,* but *investment;* not maintenance or operating expenses, deductible under subd. first, §12 (a), but capital, subject to annual allowances for exhaustion or depreciation under subd. second.

"Nevertheless, do such expenditures come within the words 'rentals or other payments required to be made as a condition to the continued use or possession of property'? We think not. The statement

> of the court below that it was conceded by both parties that the expenditures were 'additional rentals' is challenged by the government, and does not seem to have support in the record. The term 'rentals,' since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense; that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property (Dodge v. Hogan, 19 R.I. 4, 11, 31 Atl. 268, 1059; 2 Washb. Real Prop. 6th ed. §1187); and in that sense it does not include payments, uncertain both as to amount and time, made for the cost of improvements, or even for taxes (Guild v. Sampson, 232 Mass. 509, 513, 122 N.E. 712; Garner v. Hannah, 6 Duer, 262, 266, 267; Bien v. Bixby, 18 Misc. 415, 41 N.Y.Supp. 435; Simonelli v. DiErrico, 59 Misc. 485, 110 N.Y.Supp. 1045). Expenditures, therefore, like those here involved, made for betterments and additions to leased premises, cannot be deducted under the term 'rentals,' in the absence of circumstances fairly importing an exceptional meaning; and these we do not find in respect of the statute under review."

Accord: *Logan Coal & Timber Ass'n. v. Helvering,* 122 F.2d 848 at 850. Also, definition of "rent" found in the ruling of the Income Tax Unit of the Treasury Department, reading as follows:

> "The term 'rents' must be taken in its usual and ordinary sense, that is, as applying to a fixed sum to be paid at stated times for the use of property (citing cases)."

This ruling is I.T. 2970 C.B. XV-1, page 145, and is still in effect so far as we can ascertain. The above quotation is taken from the case of *Great Nat. Life Ins. Co. v. Campbell,* Oct. 30, 1953, 119 F.Supp. 57 at 60.

The facts found by the Tax Court that the parties to the lease did not intend that the value of improvements should constitute rent, and that the value of such improvements made by the lessee did not represent rent is amply sustained by the evidence, and, therefore, the position of the Tax Court must be sustained.

ANSWER TO SUBDIVISION C OF PETITIONER'S BRIEF, PAGE 25

Here again we find it somewhat difficult to ascertain from Petitioner's brief just what facts contained in the decision of the Tax Court are alleged to be erroneous, and just why they are erroneous, unless it be the statement contained on Page 26, reading as follows:

> "Even if it were correct for the Tax Court to have relied solely upon the intention of the parties, we submit that the finding that the parties did not intend the building to constitute rent is clearly erroneous."

In our discussion of Subdivision C, we must rely upon the cases we have cited in answering Subdivision B. In that connection, we cited the holding of the Supreme Court in *Blatt v. U. S.,* and quoted at length from that decision wherein the Court held that the *intention* of the parties is controlling when deciding what is or is not rent attributable to buildings or improvements placed upon leased premises by the lessee. Unless such intent is clear and unmistakable, improvements or buildings so placed on leased property will not be considered as rent.

We have cited under Subdivision B the evidence which justified the Tax Court's finding that the parties

did not intend that the improvements should constitute rent, and concluded therefrom that the taxpayers did not derive income attributable to such improvements either in 1946 or in 1952. In this respect, Subdivision C is but a repetition of Subdivision B.

On page 26 of Petitioner's brief, the following statement is made:

> "The Tax Court relied primarily (R. 52-53) upon the testimony of taxpayers that there was no intention to charge rent (R. 97-98, 132), and that the improvements did not have any value except for use by the corporation or by someone in a similar business (R. 104-105, 11-113, 134, 136-137). We submit that reliance upon this testimony is clearly erroneous."

To justify this conclusion, the following statement is made:

> "Since taxpayer was a signatory to the lease which stated that the reversion to her of the building was the consideration for the lease, her testimony to the contrary, directed at a change of the legal effect of a written instrument, should not be accorded any weight."

If this statement was correct, there might conceivably be some merit in Petitioner's contention, but the statement is not correct. There was only one written lease that had any reference to the buildings and improvements placed upon the leased property by the lessee, and that was the lease of March 17, 1947. This lease was not drawn until more than one year after the completion of the improvements and occupation of the same by the Company. It had no reference whatsoever to the terms

and conditions of the oral agreement under which the improvements, placed upon the property in 1946, were made.

The following recital is contained in this lease of March 17, 1947:

> "The consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee *has* in a building which lessee *has* constructed *and paid for* on the above-described property." (Emphasis ours) (R. 67-68)

It will further be observed that this written lease refers to a building that had theretofore been constructed and paid for by the lessee. This lease is not the agreement under which the improvements were placed upon the property, nor does it purport to have anything to do with it. It relates to a building that has been built and paid for. The reason for this lease is that under the laws of the State of Washington, an oral lease is not valid beyond one year from the date thereof (R.C.W. 59.04.010). And, for the additional reason that the Supreme Court of the State of Washington has held that:

> " . . . whether or not property annexed to the freehold becomes a part of the realty depends upon the intention of the party making the annexation." *Forman v. Columbia Theater Co.,* 20 Wn.(2d) 685 at 694 (4 & 5), 148 P.(2d) 951.

For these reasons it was necessary that a written lease be drawn to protect the rights of parties during the balance of the 6-year term of the lease.

It is submitted that the Tax Court was correct in

holding that the proof of whether or not the improvements were to be considered as rent depended upon the intention of the parties at the time these improvements were placed on the realty.

The Tax Court found that at that time there was no intent on the part of either party that any rent should be charged or considered, and that the true consideration for permitting the Company, as lessee, to place improvements upon the property of the Respondents was, as stated by the Tax Court, to make it possible for the Company to continue its uninterrupted use of these five lots for the advancement and expansion of its business.

It will be observed that the provisions of the written lease just quoted do not say that the transfer or reversion of the improvements was *the* consideration for the lease. The most that can be said is that under the terms of the written lease the right of reversion constituted some measure of consideration, providing the improvements at time of reversion should be of any value.

Grace H. Cunningham testified that they would have no such value, and by the end of the present lease in 1962 the buildings would have to be torn down because of being no longer useful.

The writer of this brief has drawn many long-term leases. In all of which provision was made requiring the lessee to place upon the leased premises buildings which would, under the terms of the lease, revert to the lessor, the cost of these buildings oft-times running into many thousands of dollars.

It is believed that this Court will take judicial notice of the fact that under a lease which provides for im-

provements to be placed on the realty with right of reversion to the lessor, that such a provision does constitute one of the considerations for the lease. Nor does such a finding of consideration bar the lessor from the protection of the 1942 amendment (1954 Tax Code) as to exclusion from gross income of the value of the building or improvements. Nor does the fact that such a provision constitutes one of the considerations for the lease, cause the cost of the building or improvements to be classified as rental and taxable as such.

Again on page 27, the Petitioner continues to carry forward the incorrect statements to which attention has just been directed.

Considering now the remaining argument of the Petitioner, the materiality or pertinence of all of the remaining argument under Subdivision C is based upon the assumption that the 1942 Amendment (Section 109, 1954 Tax Code) only exempted from gross income buildings and improvements reverting to the lessor by virtue of a cancelling of the lease, or as Petitioner terms it "windfalls."

Unless this Court is willing to accept and follow the suggested construction of the 1942 Act, then all the remaining argument under the paragraph becomes moot, wholly irrelevant and wholly immaterial. It is here asserted that because the buildings and improvements placed upon the leased premises by the Company reverted to the lessor at the termination of the lease, that, therefore, the buildings and improvements must be rent and are not exempt from gross income under the 1942 Amendment.

On page 28 a statement occurs which Petitioner must have known was incorrect. There it is stated:

> "Thus, a corporation would be able to recoup its entire costs of the building over a few years, and at the end of the lease term its principal stockholder would receive a building having value at no cost to him and *free from tax.*" (Emphasis ours)

The Petitioner must have known that Section 1019 (1954 Tax Code) was amended in 1942 and was amended for the purpose of making any improvements placed upon the leased property and reverting to the lessor subject to a tax. If the improvements so received had value, the lessor would, whenever the property was sold, pay a tax based on the value of such buildings and improvements. Petitioner knew that the lessor could not receive such improvements free from tax if the improvements had actual value. If they had no value at the time of reversion, there would be no tax, even under Petitioner's theory.

Again in the last paragraph on page 28 of Petitioner's brief, it is said:

> "Secondly, the taxpayers' testimony and the Tax Court's reliance upon the statement that the improvements lacked any value in the hands of taxpayers appears to be clearly wrong. The corporation continued to remain in business at the same place after the initial 6-year lease expired."

The "taxpayers" never did testify that the improvements did not have value to the lessee. On the contrary, the Respondents testified that the buildings and improvements were of value to the lessee. What they did testify to was that the improvements placed upon the

leased property by the lessee constituted no additional element of value to the real property in the event the Company would cease to use them.

Grace H. Cunningham testified that if she were not interested in the Company itself, and interested in the growth of the Company and the necessity for room to expand, she, as an owner, would certainly require that the lessee at the termination of its lease remove all of the improvements from the real property (R. 134,137).

She further testified that the buildings were of a special type, built for a special purpose, and useful only to the Company for that special purpose. That the improvements could only be valuable to some other manufacturer engaged in the same type of business as the Company, and that there was no other such corporation, or individual, now operating such a business in the City of Tacoma (R. 136).

It will be noted in the above quotation that the Petitioners stated:

> ". . . the Tax Court's reliance upon the statement that the improvements lacked any value in the hands of taxpayers appears to be clearly wrong."

Then on page 29, the following statement occurs:

> "The Tax Court made no findings that the building lacked value to the lessor. Indeed it assumed it had value."

How can these two statements be reconciled? On which is error predicated?

We are unable to recognize the relevancy or materiality of the argument of the Petitioner on pages 29, 30, 31 and 32 of his brief, for the reason that the same do not

relate to facts, either found by the Tax Court or contained in the record. This is clearly shown by the statement at the foot of page 32 where Petitioner states:

> "The facts of the present case, on the other hand, clearly show that the terms of the lease are that the lessee (R. 72) 'would immediately commence construction of a building on said premises of the approximate value of $25,000.00'; and that (R. 68, 71, 72) the consideration for the lease would be the transfer of all interest in the building at the termination of the lease to the lessor, after a 6-year period, a period much shorter than the life of the building."

We have shown that there is no lease in existence containing the language attributed to it by the quoted statement. This the Petitioner must have known at the time the quoted statement was made. The only written lease in existence is the lease of March 17, 1947, and no such statement is made in that lease.

Again it would seem that these continuous incorrect statements were made for the purpose of confusing the Court. We can find no merit under the entire heading "Subdivision C."

All the findings of the Tax Court herein complained of were and are abundantly supported by the evidence and records in this case.

ANSWER TO SUBDIVISIONS D AND E OF PETITIONER'S BRIEF

Unless this Court reverses the decision of the Tax Court, Petitioner's argument under both subdivisions D and E becomes wholly irrelevant.

At this juncture it might be well to view the situation as it exists in respect to certain facts of this case.

This whole matter started with the Agent who first conceived the idea that the improvements placed upon the leased premises represented in whole a liquidation in kind of lease rental, and, therefore, the exclusion from gross income did not apply. Petitioner, at that time, placed his reliance upon I.T. 4009-1950-1 C.B. 13 (R. 51). The facts on which this ruling was based were:

A owned a piece of land which had just come under an irrigation project. A leased this land to B, a farmer. The written lease provided that if B would clear, level, and properly prepare the land for irrigation, and would put in proper irrigation ditches, pipes and pumps necessary to make a complete irrigation system covering the whole land, then the cost of all such material, labor and improvements would be *"in lieu of rent"* for the full life of the lease.

The lease used the express language "in lieu of rent." This, of course, brought A squarely under the wording of the "1942 amendment" and especially under Federal Tax Regulation 111, Section 29.22 (b) (11)-1, now 1.109-1 1958 Tax Regulations.

In the letters of deficiency issued by the Commissioner in Case Nos. 55090 and 55091, the cost of the improvements placed upon the leased premises in the taxable year 1946 was fixed as $21,904.33. This item of cost was and is admittedly in error. The true cost of the improvements placed upon the leased premises in the taxable year of 1946 was $11,097 (R. 36, 65, 132).

The cost of the improvements in the taxable year of 1946 constitutes the basis of all subsequent proceedings, including the case in the Tax Court and its appeal in this Court.

A reversal of the decision of the Tax Court would require a recomputation of both claimed deficiencies (R. 14, 25, 39, 40).

In the event this Court should hold that the cost of improvements so placed upon the premises in the tax year of 1946 would represent in whole or in part a liquidation in kind of lease rentals, it would require a determination of what constituted a fair rent of the premises upon which the improvements were placed. The testimony in this case shows that the only rent that had been paid since 1928 to 1952 on the lots in question was $110.00, which constituted rent at the rate of $10 per month for eleven months. This was in the latter part of 1944 to February, 1945 (R. 64, 126).

The evidence also shows that when the written lease of March 17, 1946, expired in 1952, the real property upon which the improvements in question were located was again leased to the Company for a period of ten years, the Company to pay the taxes, a monthly rental of $10, insurance and cost of any improvements, which, if made, would revert to the lessor at the end of the 10-year period (R. 37, 76, 77).

The undisputed evidence also shows that these improvements placed by the lessee on the leased property would be obsolete by 1962 and would have to be torn down (R. 136).

The undisputed evidence of the lessor was that the improvements placed by the lessee upon the leased premises did not constitute any element of value to the lessor for the reason that the improvements were of a highly specialized nature, not adaptable for any other use than that of the Company, or some other company engaged in the same line of business, and that there was no other such company in the City of Tacoma (R. 134, 136, 137, 138).

When a determination has been made of the proper annual rental (which the Respondents assert would not be in excess of $10 per month and tax payments) such an amount might then be found to be taxable gain to the lessor in each of the six years, being the life of the lease.

If, however, it should be determined that the improvement placed upon the leased premises by the lessee did not constitute any element of value to the lessor, then there could be no taxable gain even if a fair rental basis was determined.

The whole matter now simmers down to but one proposition, and that is: Was it the intent of the parties, lessor and lessee, at the time of the placing of the improvements on the leased property by the lessee that the lessee should pay no rent other than taxes and insurance? The Tax Court found that such was the intent of the parties and concluded their opinion with the following statement (R. 53):

> "We are satisfied from this testimony and from the acts of the parties to the lease that they did not intend that the value of the improvements should

constitute rent either at the time of construction or at the termination of the lease. We have therefore concluded and found as a fact that the value of such improvements made by the lessee did not represent rent at the time of construction or upon termination of the lease. It follows that the petitioners did not derive income attributable to such improvements either in 1946 or in 1952."

CONCLUSION

It is respectfully submitted that Respondents have shown that the facts found by the Tax Court in this case are fully sustained by the evidence and surrounding circumstances, and, therefore, the decision of the Tax Court (R. 54) must be sustained.

Respectfully submitted,

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May, 1958.